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Expiration of tax cuts will impact acquisition strategies of multifamily investors

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The Bush Era tax cuts are set to expire this December, which could have a significant impact on the near and long-term acquisition strategies of multifamily investors. The tax cuts, which will expire on Dec. 31, means capital gains taxes will revert to 20% from their 70-plus-year low of 15%. Also, barring legislative intervention, the tax rate on dividends will jump from 15% to 39.6% for top earners. When substantial tax code changes took effect in 1986, including a capital gains rate increase from 20% to 28%, investor liquidations nearly doubled the total realized capital gains from the previous year. Despite the decline in investment values over the last two years, many investors will likely follow this liquidation strategy, locking in their profits rather than waiting for investments to appreciate sufficiently to offset the 5% tax hike.

Recent commentary by treasury secretary Geithner suggests the Obama administration will allow the Bush tax cuts to expire. The reluctance to endorse even greater rate hikes likely stems from concern more significant increases could further impede the economic recovery. Considering long-term capital gains taxes have averaged 26% over the last 50 years, even hitting 40% in 1976, risk of further increases once the economy stabilizes remain high. As a result, though multifamily investors often choose to hold assets in the year following a rate hike, perceived tax-related risks may encourage them to continue selling assets in 2011.

In response to the increase in capital gains taxes, apartment-building investors' ability to defer capital gains indefinitely through 1031 exchanges will become even more attractive. Since 2002, the year before the capital gains tax rate was reduced to a 70-plus-year low; the number of 1031 exchanges has fallen by nearly half. As capital gains taxes rise, the share of deals involving 1031 exchanges will increase substantially, as sellers will be further discouraged from taking profits from the investment real estate sector.

The economic recovery will continue to make slow, choppy progress through the remainder of 2010 and into early 2011. While risks such as another slide in the housing market and slipping business/consumer confidence persist, a double-dip recession remains unlikely. Still, several forces will drag on growth in the near term, hampering the pace of recovery. To start, the consumer sector, which accounts for 70% of U.S. GDP, will remain strapped by tight credit conditions and high unemployment over the next several quarters. In addition, the extended downturn has driven a shift in consumer psychology, leading households to pay down debt and increase savings as opposed to spending disposable income on goods and services. This places the onus of transitioning the recovery into a self-perpetuating expansion cycle on businesses, which first need to regain sufficient confidence to initiate more substantive hiring and capital spending.

While corporate profits have soared in recent quarters, large companies have amassed record-high levels of cash, reducing their reliance on credit markets to fuel growth but also hampering the pace

of the economic recovery. Small businesses, which account for nearly half of all private-sector employment, face greater challenges at this stage of the cycle and will drag on the recovery. Lacking significant cash stockpiles, small businesses continue to encounter difficulties securing credit for expansion, despite modest loosening in lending conditions recently.

Despite these political and economic challenges, apartments have taken the lead in the national recovery and will likely post notable occupancy and rent gains in major markets over the next year. Very modest private-sector job growth and stronger household formation released some of the pent-up renter demand accumulated through the downturn. Improvements were broad-based, with 70% of all major U.S. apartment markets recording occupancy gains. As 2010 progresses, more pent-up demand for apartments will be released, particularly among the estimated 2.2 million young adults who have moved back with their parents since 2005. The outlook brightens considerably for 2011 and beyond amid expectations for improved economic growth, powerful demographic shifts supporting a surge in renter demand and limited new construction. These trends will likely result in a shortage of apartments nationwide, driving rent growth to above-average levels by 2012 or 2013.

State of Connecticut

Apartment Sales 2000 - 2010

2010 (as of 9/1)*: 798 units traded for \$59,150,000

2009: 2,251 units

traded for \$188,532,880

2008: 5,532 units

traded for \$758,785,000

2007: 6,247 units

traded for \$891,958,998

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